



Banking Q2FY2007 earnings review

After two quarters of relatively dull performance the banking sector gets reason to party

- ◆ After two relatively dull quarters, the latest quarterly results truly justified the run-up in the banking stock prices. The exuberance in the banking sector is based on the core fundamentals and improved visibility in the earnings of the sector, a glimpse of which we have seen during Q2FY2007.
- ◆ The net interest income (NII) witnessed a handsome growth, backed by a strong advances growth and the relatively stable net interest margins (NIMs). Higher growth in the fee income helped a commendable growth in the core operating profits.
- ◆ With the benchmark yields down almost 50 basis points from the quarter ended June 30, 2006, instead of a mark-to-market provisions charge that was seen in the previous couple of quarters, we saw most banks writing back excess provisions. This kept the overall provisions down and helped the robust growth in profits.
- ◆ Based on the improved visibility in the earnings for the banking sector, we have revised the earnings for certain banks. We feel that with the busy season ahead the banking sector is poised to see better times. Our top picks among the public sector banks remain Bank of India, Canara Bank and Punjab National Bank while in the private banking space UTI Bank is our preferred choice.

Handsome growth in NII

The NII for the public sector banks (PSBs) excluding State Bank of India (SBI) saw a strong 16.8% year-on-year (y-o-y) growth with Bank of India (BOI) reporting the highest growth in its NII at 46.8% year on year (yoy). Among the private banks the NII increased by a whopping 43.9% yoy ahead of our expectations of a growth of 37.4% yoy (adjustments done for ICICI Bank) with ICICI Bank reporting a commendable 47.4% y-o-y growth.

...backed by strong growth in advances

The deposit and advances growth remained robust as on September 30, 2006 on a y-o-y basis as well as on a sequential basis. However a clear trend has been emerging among PSBs. The PSBs that have gone in for selective credit and deposit growth have improved their margins compared with the ones that have seen rapid advances and deposit growth, but have also eroded their margins. For example, Bank of Baroda and Allahabad Bank, which have had the highest growth in the advances amongst all the PSBs (and also 1.5x the industry growth), have eroded their NIMs substantially.

... and stable to improving NIMs

The NIMs for Q2FY2007 show that barring the PSBs that have had a faster balance sheet growth all the banks have

| Banks Rs (crore) | Net interest income | | | | Core operating profit | | | | Net profit | | | |
|----------------------------------|---------------------|----------------|-------------|------------|-----------------------|----------------|-------------|-------------|----------------|----------------|-------------|-------------|
| | Q2FY07 | Q2FY06 | % yoy | % qoq | Q2FY07 | Q2FY06 | % yoy | % qoq | Q2FY07 | Q2FY06 | % yoy | % qoq |
| Allahabad Bank | 389.9 | 367.6 | 6.1 | -0.3 | 218.0 | 194.0 | 12.4 | -1.2 | 210.0 | 168.0 | 24.8 | 63.8 |
| Andhra Bank | 330.9 | 288.6 | 14.7 | -1.3 | 206.0 | 171.0 | 20.2 | 2.6 | 146.0 | 133.0 | 10.2 | 25.8 |
| Bank of Baroda | 890.8 | 781.8 | 13.9 | 1.0 | 545.0 | 381.0 | 43.1 | -0.8 | 288.0 | 259.0 | 11.3 | 76.6 |
| Bank of India | 849.4 | 578.6 | 46.8 | 11.1 | 488.0 | 354.0 | 37.9 | 2.3 | 212.0 | 132.0 | 60.5 | 1.6 |
| Canara Bank | 981.1 | 806.7 | 21.6 | 3.5 | 605.0 | 573.0 | 5.6 | 2.7 | 362.0 | 307.0 | 18.0 | 89.5 |
| Corporation Bank | 316.7 | 306.5 | 3.3 | -2.5 | 241.0 | 232.0 | 3.9 | -1.2 | 127.0 | 106.0 | 20.3 | -11.9 |
| PNB | 1,362.8 | 1,190.8 | 14.4 | 5.4 | 818.0 | 613.0 | 33.4 | -8.9 | 505.0 | 422.0 | 19.7 | 37.4 |
| UBI | 627.5 | 602.3 | 4.2 | -1.1 | 390.0 | 325.0 | 20.0 | -2.3 | 194.0 | 61.1 | 217.8 | 16.4 |
| Total - PSBs excl SBI | 5,749.0 | 4,922.8 | 16.8 | 3.2 | 3,511.0 | 2,843.0 | 23.5 | -1.9 | 2,045.0 | 1,588.0 | 28.8 | 37.6 |
| SBI | 3,898.7 | 3,608.0 | 8.1 | 0.4 | 2,465.0 | 1,736.0 | 42.0 | -6.1 | 1,184.0 | 1,215.0 | -2.5 | 48.3 |
| HDFC Bank | 845.6 | 612.1 | 38.1 | 3.4 | 643.0 | 459.0 | 40.1 | 4.2 | 263.0 | 200.0 | 31.7 | 9.9 |
| ICICI Bank | 1,577.0 | 1,069.5 | 47.4 | 6.9 | 1,326.0 | 804.0 | 64.9 | 16.0 | 755.0 | 580.0 | 30.2 | 21.8 |
| UTI Bank | 365.2 | 255.5 | 43.0 | 13.5 | 252.0 | 167.0 | 50.9 | -5.6 | 142.0 | 109.0 | 30.2 | 17.8 |
| Total - pvt banks | 2,787.8 | 1,937.1 | 43.9 | 6.6 | 2,221.0 | 1,430.0 | 55.3 | 9.6 | 1,160.0 | 980.0 | 30.5 | 18.4 |

Source: Sharekhan research

NIMs - mixed outcome

| Banks | H1FY07 | H1FY06 | yoy chg (in bps) | Q2FY07 | Q2FY06 | Q1FY07 | yoy chg (in bps) | qoq chg (in bps) |
|------------------|--------|--------|---------------------|--------|--------|--------|---------------------|---------------------|
| Allahabad Bank | 2.79 | 3.05 | -26 | 2.60 | 3.07 | 3.01 | -47 | -41 |
| Andhra Bank | 3.81 | 3.68 | 13 | 3.91 | 3.55 | 3.72 | 36 | 19 |
| Bank of Baroda | 3.24 | 3.37 | -13 | 3.08 | 3.40 | 3.39 | -32 | -31 |
| Bank of India | 2.95 | 2.57 | 38 | 3.06 | 2.63 | 2.91 | 43 | 15 |
| Canara Bank | 2.83 | 2.89 | -6 | 2.82 | 2.83 | 2.79 | -1 | 3 |
| Corporation Bank | 3.20 | 3.56 | -36 | 2.98 | 3.65 | 3.42 | -67 | -44 |
| PNB | 4.16 | 4.00 | 16 | 4.22 | 3.99 | 4.10 | 23 | 12 |
| UBI | 2.85 | 3.11 | -26 | 2.76 | 3.18 | 2.94 | -42 | -18 |
| SBI | 3.32 | 3.13 | 19 | 3.27 | 3.13 | 3.37 | 14 | -10 |
| HDFC Bank | 4.00 | 4.00 | - | 4.00 | 4.00 | 4.00 | - | - |
| ICICI Bank | 2.50 | 2.40 | 10 | 2.50 | 2.40 | 2.50 | 10 | - |
| UTI Bank | 2.80 | 2.73 | 7 | 2.92 | 2.80 | 2.68 | 12 | 24 |

Source: Sharekhan research

Quarterly figures are calculated if not reported, half yearly numbers are as reported by the banks

shown a healthy expansion in the NIMs on a yoy as well as quarter-on-quarter (q-o-q) basis. The NIM expansion was limited to an extent for the following reasons.

- ♦ Many of the banks had taken high cost deposits during the liquidity crunch between December 2005 and June 2006.
- ♦ The yields on investments have been falling as high yielding investments are getting redeemed in favour of lower yielding ones. The redemption has been done partially to fund the strong advances growth.

We believe that as the high cost deposits get out of the system in this quarter and the impact of re-pricing of advances (as most banks have hiked lending rates) is felt fully, the NIMs will improve further.

Core operating profit reports robust growth

Driven by a strong growth in the NII coupled with the strong growth in the fee and other incomes (excluding the treasury income) the core operating profit growth for the PSBs excluding SBI witnessed a robust 23.5% y-o-y increase, marginally lower than our estimates of a 28.2% growth, with Bank of Baroda (BOB) reporting the highest growth in its core operating profit at 43.1% yoy. The fee income of the PSBs grew by a strong 10.5% yoy and 1.7% qoq.

The core operating profit of the private banks grew by a handsome 55.3% yoy as the strong growth in the NII was equally supported by a 50% yoy and a 6.7% q-o-q growth in the fee income. Among the private banks ICICI Bank reported a commendable 64.9% y-o-y growth in its core operating profit.

Strong upswing in profits

The PSBs excluding SBI reported a strong net profit growth of 28.8% yoy to Rs2,044.9 crore, slightly below our estimates of Rs2,103 crore. Bank of India reported an excellent set of numbers with a net profit growth of 60.5% yoy compared to our estimates of a growth of 52.5% yoy.

All three private sector banks—HDFC Bank, ICICI Bank and UTI Bank--reported a 30% plus y-o-y net profit growth, with ICICI Bank reporting a net profit growth at 30.2% yoy compared to our estimates of a 24.7% growth yoy.

Asset quality—no major surprises yet

The asset quality of the sector remains healthy; some banks have opted to utilise the write back in investment depreciation towards making higher non-performing asset (NPA) provisions.

Valuations and view—many of the banks see upgrades in earnings

Based on the improved visibility in the earnings for the banking sector, we have revised the earnings for certain banks. We feel that with the busy season ahead the banking sector is poised to see better times. Our top picks among the public sector banks remain Bank of India, Canara Bank and Punjab National Bank while in the private banking space UTI Bank is our preferred choice.

The Bankex has gained 38.9% during Q2FY2007 and 11.1% till date from the May 10, 2006 market highs. We believe that the run-up is commensurate with the improvement in the fundamentals and improved visibility in the earnings of the sector, a glimpse of which we have seen during Q2FY2007. We feel that with the busy season ahead, the banking sector is poised to see better times.

| Banks Rs (crore) | Advances | | | Deposits | | |
|---------------------|-----------|-----------|------------|-----------|-----------|------------|
| | H1FY07 | H1FY06 | % yoy chng | H1FY07 | H1FY06 | % yoy chng |
| Allahabad Bank | 35,581.0 | 24,131.0 | 47.4 | 54,006.0 | 43,700.0 | 23.6 |
| Andhra Bank | 23,600.0 | 19,153.0 | 23.2 | 32,513.0 | 29,869.0 | 8.9 |
| Bank of Baroda | 70,956.7 | 48,935.6 | 45.0 | 107,681.5 | 86,145.2 | 25.0 |
| Bank of India | 73,689.0 | 59,165.0 | 24.5 | 103,294.0 | 85,856.0 | 20.3 |
| Canara Bank | 82,571.0 | 65,139.0 | 26.8 | 122,121.0 | 102,736.0 | 18.9 |
| Corporation Bank | 28,004.0 | 20,226.0 | 38.5 | 38,017.0 | 29,761.0 | 27.7 |
| PNB | 82,340.0 | 63,868.0 | 28.9 | 128,415.0 | 109,414.0 | 17.4 |
| UBI | 61,444.0 | 47,498.0 | 29.4 | 78,528.0 | 68,673.0 | 14.4 |
| SBI | 288,840.0 | 238,351.0 | 21.2 | 392,615.0 | 380,052.0 | 3.3 |
| HDFC Bank | 49,326.0 | 36,764.0 | 34.2 | 63,447.0 | 45,446.0 | 39.6 |
| ICICI Bank | 155,403.0 | 107,071.0 | 45.1 | 189,499.0 | 120,452.0 | 57.3 |
| UTI Bank | 29,121.0 | 18,404.0 | 58.2 | 48,920.4 | 34,055.0 | 43.7 |

Source: Sharekhan research

Ratio of upgrades to downgrades at 8:1

| | New EPS estimates (Rs) | | Old EPS estimates (Rs) | | % yoy change | |
|-------------------|------------------------|---------|------------------------|---------|--------------|---------|
| | FY2007E | FY2008E | FY2007E | FY2008E | FY2007E | FY2008E |
| Upgrades | | | | | | |
| Allahabad Bank | 15.7 | 21.8 | 14.6 | 21.8 | 7.4 | 0.0 |
| Andhra Bank | 11.3 | 13.3 | 10.7 | 13.3 | 5.8 | 0.0 |
| Bank of India | 18.8 | 22.2 | 15.5 | 18.0 | 21.4 | 23.2 |
| Canara Bank | 36.8 | 45.9 | 32.0 | 39.0 | 15.0 | 17.7 |
| Corp Bank | 36.7 | 46.5 | 35.1 | 43.1 | 4.6 | 7.9 |
| HDFC Bank | 36.1 | 47.9 | 35.9 | 47.0 | 0.5 | 1.9 |
| PNB | 56.1 | 70.7 | 51.8 | 65.2 | 8.4 | 8.4 |
| UTI Bank | 21.6 | 27.8 | 20.8 | 26.3 | 3.8 | 5.7 |
| Downgrades | | | | | | |
| Bank of Baroda | 26.8 | 36.6 | 26.7 | 38.1 | 0.4 | -3.8 |

Source: Sharekhan research

Valuation table

| | Price (Rs) | Price target | PER (x) | | | P/BV (x) | | | P/PPP | | | RoE (%) | | |
|----------------|---------------|-----------------|---------|-------|-------|----------|-------|-------|-------|-------|-------|---------|-------|-------|
| | | | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E |
| Allahabad Bank | 89.7 | 106.0 | 5.7 | 5.7 | 4.1 | 1.1 | 1.0 | 0.8 | 5.7 | 5.7 | 4.1 | 21.3 | 17.9 | 21.4 |
| Andhra Bank | 92.2 | 109.0 | 9.2 | 8.2 | 6.9 | 1.5 | 1.4 | 1.2 | 5.8 | 5.0 | 4.1 | 19.0 | 17.9 | 18.9 |
| BOB | 270.6 | 327.0 | 12.0 | 10.1 | 7.7 | 1.3 | 1.2 | 1.0 | 4.9 | 4.2 | 3.5 | 11.2 | 11.9 | 14.1 |
| BOI | 177.1 | 185.0 | 12.3 | 9.4 | 8.0 | 1.7 | 1.5 | 1.3 | 5.1 | 4.0 | 3.5 | 14.8 | 17.2 | 17.7 |
| Canara Bank | 292.2 | 320.0 | 8.9 | 7.9 | 6.4 | 1.7 | 1.4 | 1.2 | 4.4 | 3.9 | 3.4 | 20.3 | 19.5 | 20.7 |
| Corp Bank | 397.2 | 425.0 | 12.8 | 10.8 | 8.5 | 1.7 | 1.5 | 1.3 | 5.4 | 5.0 | 4.2 | 13.8 | 14.7 | 16.4 |
| PNB | 519.7 | 600.0 | 11.4 | 9.3 | 7.4 | 1.7 | 1.5 | 1.3 | 5.2 | 4.8 | 4.2 | 16.4 | 17.5 | 19.0 |
| SBI | 1,126.3 | ** | 13.4 | 12.6 | 9.9 | 2.1 | 1.9 | 1.6 | 5.2 | 5.0 | 4.5 | 17.1 | 16.0 | 17.7 |
| UBI | 132.3 | 150.0 | 9.9 | 7.3 | 5.9 | 1.5 | 1.3 | 1.1 | 4.2 | 3.6 | 3.1 | 15.8 | 18.8 | 20.0 |
| HDFC Bank | 1,000.8 | 1,080.0 | 35.7 | 27.7 | 21.3 | 5.9 | 5.1 | 4.2 | 15.2 | 11.0 | 8.5 | 17.6 | 19.2 | 21.1 |
| ICICI Bank | 773.1 | ** | 27.1 | 21.0 | 17.5 | 3.1 | 2.8 | 2.5 | 14.5 | 10.8 | 8.8 | 13.6 | 14.7 | 16.1 |
| UTI Bank | 440.7 | 490.0 | 25.3 | 20.4 | 15.5 | 4.3 | 3.7 | 3.1 | 12.3 | 10.1 | 7.6 | 18.4 | 19.3 | 21.5 |

Note: ** under review

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